

soundwaves

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THRIVING IN TOUGH TIMES: SAVVY EFFICIENCY AND SMART MANAGEMENT ARE KEYS TO NON-PROFIT SUCCESS

Two out of three people today believe that charities are honest and ethical in the use of their funds, according to an Independent Sector report released August 14. While this may be good news to some organizations, it still means that a third of Americans don't have such a high opinion of the non-profit sector.

More interesting, perhaps, is another statistic from *Keeping the Trust: Confidence in Charitable Organizations in an Age of Scrutiny*: donors who have high confidence in charities tend to give about 50 percent more each year than those who don't.

Non-profit organizations "enjoy broad public support that has remained fairly stable over the last decade," said Peter Shiras, Independent Sector's senior vice president for programs. But he cautioned that "non-profit organizations should not feel complacent. Much can and should be done by the leaders of non-profit organizations to ensure that their organizations live up to the highest standards of ethical behavior and operational effectiveness."

Your organization can take some important steps to minimize problems and make sure that the message you're conveying to donors is one of savvy efficiency and smart financial management. For example, managing staffing in tight times is critical.

MANAGING LAYOFFS

If you can keep everyone employed during tough times (see "Avoiding a Layoff"), that's obviously the best solution. Sometimes, however, layoffs are inevitable. "If you

determine that staff cuts are essential, there are some steps you can take to minimize the likelihood that an unhappy ex-employee will turn around and sue you," Steven Baderian, a partner in the White Plains office of the law firm of Jackson Lewis, told *Soundwaves*.

Baderian points out that it's critical to make sure that everyone in your organization understands the reasons for a layoff. "This is particularly important if a discrimination charge is filed, as the employer may have to produce witnesses who can articulate a legitimate business reason for the reduction," he says.

In addition, if your organization has a written policy on reductions in force, review it to understand who fits the criteria defined in the policy and to what benefits they may be entitled. Common criteria for evaluating and selecting employees in these circumstances include merit, seniority, and whether a worker is a part-timer, a contract employee, or a full-time staff member. In addition, it's important to take into account what job functions will remain after a layoff to minimize the chances of employees charging that you weren't eliminating their jobs — just them.

You may also need or want to obtain waivers and releases. Baderian cautions that "if the employees selected for layoff are over 40, any release agreement given to them must

AVOIDING A LAYOFF

Before resorting to a staff layoff, charities should consider whether other options are available that can keep people on the job and reduce the likelihood that your organization will face an employment claim.

Some options include:

- freezing wages;
- postponing wage increases to improve short-term cash flows;
- work furloughs;
- reducing work hours (with proportionate pay cuts);
- assessing expected job attrition; and
- freezing hiring.

It may also be possible to transfer affected employees to other vacant positions, or to offer buyout packages to entice people to retire early or leave the organization.

Source: Jackson Lewis, LLP. With 350 attorneys and 20 offices nationwide, Jackson Lewis represents management exclusively in all matters relating to employment, labor, benefits, and immigration law and related litigation. Please visit our Web site: www.jacksonlewis.com.

"Leaders within the charitable sector must constantly be diligent in upholding the highest standards of ethical behavior."

from Keeping the Trust

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comply with the Older Workers Benefit Protection Act.” He notes that this provision will affect the timing of any layoff, since affected employees must be given 45 days to consider whether to sign the release. In addition, they must be provided with a significant amount of statistical data about their co-workers.

Unless you’re a very large non-profit and are laying off a lot of people, you’re probably exempt from the layoff notice requirements under the federal plant closing statute. But double-check with your attorney to be certain.

Finally, make sure you develop a communications script to help managers go through the process of laying off employees, including:

- Being firm and consistent while keeping on target,
- Explaining whether the layoff is permanent or temporary,
- Describing final paychecks, including accrued sick leave and vacation, and
- Discussing any outplacement services available to help employees find new work.

The communications script should also include a written explanation of any available severance benefits, health insurance continuation or COBRA rights, insurance conversion rights, and other termination payments.

“Layoffs are very stressful,” says Baderian. “Charities that have managed their layoffs intelligently and shown respect for their employees generally face fewer problems down the line.”

GETTING AN AUDIT

A well-orchestrated layoff, while difficult, can be a signal to donors that you’re trying to respond intelligently to financial realities. Another step your organization might consider is to undertake an outside review of your books, such as an audit.

With an audit, you have a piece of paper that you can hold up to prove there’s nothing wrong with your operations.

Roman Blazauskas, vice president of finance and treasurer, Consumer Healthcare Products Association (CHPA), told Soundwaves that an audit can “give a sense of confidence in the financial statements of the organization.” Tom Clark, executive vice president of the Association of Fundraising Professionals, agrees. Clark says that if your organization is raising money, “this provides assurances to your constituency that you’re being good stewards of the funds.”

CPA Ted Browning, a partner in the mid-Atlantic office of Johnson Lambert & Co., points out that “non-profits generally have modest staffs, and they are usually very mission-focused. So a lot of what we do is bring professional skepticism into the mix — and it’s amazing the kinds of comparisons and analyses we can make as soon as we focus on the finances rather than just the mission.”

In general, the audit process involves two phases: planning and verification. In the planning phase, an audit team will come in and first look to see what internal controls you have in place. These could include cash receipts and cash disbursements, the membership database, contributions, and fundraising.

Once your auditors understand what controls are in place, they will test the system to see if those controls are effective. In the verification phase, the auditors will select transactions and have management pull all the supporting documentation in order to verify that what the papers say happened actually did. For example, they may look at your organization’s budget to make sure that a transaction has gone through the appropriate budget approval process. Auditors might also make firsthand observations about an activity, or even talk to outside parties to get additional information.

Ted Browning notes that his firm always looks closely at a non-profit organization’s budget, comparing it to the actual financial numbers as well as to the prior year’s budget.

“Budgets in the non-profit sectors are a big deal,” Browning told *Soundwaves*, “because in addition to being management tools they are a lot like authorizing tools. Because that’s how the board says, ‘this is what we want you to do.’”

In the end, you can generally expect your audit documents to include:

- A complete set of financial statements, with descriptive footnotes and a report;
- A management letter recapping the auditor’s observations and recommendations.

While the basic audit report is intended to be shared with third parties, including donors, the management letter is not. In addition to reiterating some of the limitations of the audit, the management letter is where the auditor might tell the board if management had not been cooperative during the audit process.

Finally, while management needs to be involved in the audit process, it’s also important for board members to seek out a direct relationship with the auditor. With management out of the room, board members may feel freer to raise questions or voice concerns.

CHPA’s Blazauskas stresses that board members are responsible for overseeing management. As result, he says he always recommends to his committee “that they go into executive session with the auditor to discuss any questions they might have.”

Soundwaves thanks Steven D. Baderian, partner in the White Plains, NY, office of Jackson Lewis LLP, for his assistance. Jackson Lewis is a national law firm representing management exclusively in workplace law and related litigation: One North Broadway, White Plains, NY 10501; tel.: 914-514-6103; email: baderias@jacksonlewis.com.

Soundwaves also thanks Ted Browning, a partner in the mid-Atlantic regional office of Johnson Lambert & Co., for his assistance. Johnson Lambert is a CPA and consulting firm specializing in the association and insurance industries: 7500 Old Georgetown Road, Bethesda, MD, 20814; tel.: 301-656-0040; email: tbrowning@jlco.com.

IRS FORM 990: ONE FORM MEANS A LOT

Just because you have tax-exempt status doesn't mean you don't have to file a tax form. Like corporations and private individuals, non-profit organizations have to file with the Internal Revenue Service each year. The document: IRS Form 990, *Return of Organization Exempt From Income Tax*.

"Many non-profits don't realize that they're responsible for filing tax returns," says Jan Harper, director of member services at the Michigan Nonprofit Association. "But if they don't file, they face penalties."

Obviously, meeting your legal obligations under U.S. tax law is a pretty important responsibility. But there's another reason you should pay attention to that tax form: it's your opportunity to tell your financial story to community foundations, private donors, and the public at large.

Form 990 is a public document, and by law non-profits must make their tax forms available to anyone who requests a copy. The form asks for a lot of valuable information about your mission and how you're carrying it out. Fill it out right — and you've got a solid document that tells the public what you do and how you're doing it.

Here are a few specifics to keep in mind when working on your 990 filing.

● **Articulate your organization's mission.**

After all, donors are more likely to invest their time and money in non-profits that can define who and what they are.

● **Classify your expenses carefully.**

Just as there are many ways to slice a pie, there are a number of different ways that your organization can classify expenses. Ideally, you want as much of your dollars to be used on program services as possible, as opposed to "management & general" or "fundraising." Yet some organizations report management & general or fundraising expenses that might better be included under program services. Getting this sorted out properly is important, because you don't want to give the mistaken impression that you aren't using

donor dollars efficiently.

The Council of Better Business Bureaus' *Standards for Charitable Solicitations* state that "reasonable use of funds requires that a) at least 50 percent of total income from all sources be spent on programs and activities directly related to the organization's purposes; b) at least 50 percent of public contributions be spent on the programs and activities described in solicitations, in accordance with donor expectations; c) fundraising costs not exceed 35 percent of related contributions; and d) total fundraising and administrative costs not exceed 50 percent of total income." Of course, these are only guidelines, but they're a good starting point for figuring out how your non-profit measures up.

● **List all your directors and officers.**

While you can use your organization's address for all directors and officers, you must list everyone's name. And, in fact, this section can be very useful. Peter Swords, former executive director of the Nonprofit Coordinating Committee of New York, writes in *How to Read the Form 990 & Find Out What It Means* that this is "significant information since the quality of an organization's board members may reflect on the organization itself." He points out that everything from who serves on a board to whether the board has broad public representation can tell a donor a lot about your charity.

● **Check your math.**

Six Things the Board President Should Check Before the 990 Is Filed cites one study that found that 67 percent of all 990s had errors in the math.

Sources:

* *The Standards for Charitable Solicitations* are online at www.give.org/standards/cbbbstds.asp.

* *How to Read the Form 990 & Find Out What It Means* is online at www.npcny.org/Form_990/990.htm#no6.

* *Six Things the Board President Should Check Before the 990 Is Filed* was published in Board Café, an electronic newsletter for members of non-profit boards of directors. The article is online at www.boardcafe.org/bc498.html.

Tax Issues of Engaging in a Trade or Business

Many non-profits engage in activities that generate a profit. If your organization is one of them, it's important to know that these activities can result in additional tax filings and federal income tax liabilities — and could even jeopardize your tax-exempt status if you're not careful. As a result, directors and officers of non-profit organizations need to be familiar with the federal income tax concepts of unrelated trade or business (UTB) and unrelated business taxable income (UBTI).

A UTB is a trade or business, regularly carried on, that does not contribute importantly (other than through the production of funds) to the organization's mission — such as the operation of a restaurant by a church. UBTI is an organization's net income from unrelated trade or business.

UNRELATED TRADE OR BUSINESS

In order to be "regularly carried on," an activity must have a frequency and continuity, and it must be pursued in a manner generally similar to the comparable activity of a for-profit organization. An annual fundraising event generally doesn't fall into this category. But the conduct of year-round business activities for even one day each week could.

There are several important exclusions from the definition of a UTB, including:

- Any trade or business in which the bulk of the work is performed by volunteers.
- The conduct of a trade or business for the convenience of an organization's members, students, patients, officers, or employees.
- The selling of merchandise that has largely come into the organization as gifts or contributions.

Dividends, interest, royalties, and rental

income from real property are not considered UBTI for tax purposes, except for rental income from debt-financed property. However, certain interest, annuities, royalties, and rents derived from for-profit organizations of which the non-profit parent owns more than 50 percent are subject to tax. For example, if an exempt organization owns more than 50 percent of the stock of a for-profit corporation, and the exempt organization makes loans to the for-profit corporation, the interest income received will be subject to tax.

UBTI TAX IMPLICATIONS

Income tax is imposed on the unrelated trade or business income of otherwise

tax-exempt organizations. The tax, which is comparable to that on ordinary businesses, is reported on Form 990-T.

If an organization derives an excessive percentage of its total revenue from unrelated activities, the IRS may challenge the organization's right to retain its exemption. The determination of whether total revenue from unrelated activities is excessive is made on a case-by-case basis. The courts have declined to set a percentage threshold.

If you think your organization may be at risk of having excessive UBTI and thus jeopardizing your non-profit status, you should consider spinning off the UTB into a

for-profit subsidiary. The subsidiary can then pay dividends to the non-profit, and those dividends will be non-taxable to your organization.

Best of all: the activities of the subsidiary will not affect your tax-exempt status. Consult with your tax advisor to make sure it is set up properly.

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